

**IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS**

FILED

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CLERK, U.S. DISTRICT COURT
SOUTHERN DISTRICT OF ILLINOIS
EAST ST. LOUIS OFFICE

**DAWN ZOBRIST, individually
and on behalf of others similarly situated,**

Plaintiff,

v.

**VERIZON WIRELESS, CELLCO
PARTNERSHIP and VERIZON
COMMUNICATIONS, INC.,**

Defendants.

No. 02-CV-1000-DRH

MEMORANDUM AND ORDER

HERNDON, District Judge:

I. Introduction and Background

Now before the Court is Dawn Zobrist's motion to remand (Doc. 20). Defendants oppose the motion. Based on the pleadings and the applicable case law, the Court lacks subject matter jurisdiction over Zobrist's claims and grants the motion to remand.

On August 9, 2002, Dawn Zobrist, individually and on behalf of others similarly situated, filed a two-count complaint for breach of contract and statutory fraud against Verizon Wireless, Celco Partnership and Verizon Communications Inc., in the Madison County, Illinois Circuit Court (Doc. 2).¹ Zobrist alleges that

¹ Zobrist purports to represent the following class of persons:
All persons in Illinois who were billed an "Early Cancellation Fee"

Defendants' "Early Cancellation Fee" is charged to penalize customers who cancel their cellular accounts, and, therefore, is not a valid contract provision under Illinois law. Specifically, Zobrist's complaint alleges:

Plaintiff and a nationwide class of Verizon Wireless customers bring this breach of contract and statutory fraud action against Verizon Wireless for wrongly imposing an "Early Cancellation Fee" upon them. This case has nothing to do with the services Verizon Wireless provides or the rates it charges for those services. Instead, this case is about the breach of contract and fraud Verizon Wireless uses to penalize and collect an extra \$175.00 from customers who cancel their service agreements.

(Doc. 2, ¶ 1).

On September 9, 2002, Defendants removed the case to this Court based on federal question jurisdiction, **28 U.S.C. § 1331** (Doc. 1). Defendants maintain that Zobrist's claims are preempted by the Federal Communications Act, **47 U.S.C. §§ 151, et seq.** ("FCA"), because the fee Zobrist is challenging is part of the overall rate Defendants charge its customers and because Zobrist is challenging the reasonableness of that fee. *See 47 U.S.C. § 332(c)(3)(A); Bastien v. AT&T Wireless Services, Inc.*, 205 F.3d 983, 986 (7th Cir. 2000); *Boomer v. AT&T Corp.*, 309 F.3d 404 (7th Cir. 2002).

Pending before the Court is Zobrist's motion to remand (Doc. 20). Zobrist argues that the Court lacks federal question jurisdiction over her state law

(or substantially similar termination or cancellation fee) by Verizon Wireless when they cancelled their agreement before the end of its Service Term

claims. She contends that she is not challenging the rates charged for the cellular services or for market entry, but rather one of Verizon's "other terms and conditions." Specifically, Zobrist contends that her claims challenge the Early Cancellation Fee Defendants impose upon every customer who cancels his account with Defendants. Zobrist also maintains that the Early Cancellation Fee is an invalid penalty clause and not enforceable under Illinois law.

II. Analysis

An action cannot be removed to federal court if it could not have originally been filed in federal court. **Gossmeier v. McDonald**, 128 F.3d 481, 487 (7th Cir. 1997); 28 U.S.C. § 1441(a). The party seeking removal has the burden of establishing the jurisdiction of the district court. **Wellness Community National v. Wellness House**, 70 F.3d 46, 49 (7th Cir. 1995).

In determining whether federal question jurisdiction exists, the starting point is the "well-pleaded complaint" rule which provides that "federal question is presented on the face of the plaintiff's properly pleaded complaint." **In the Matter of the Application of County Collector of the County of Winnebago, Illinois**, 96 F.3d 890, 895 (7th Cir. 1996). The defendant cannot remove a case to federal court by simply asserting a federal question in his responsive pleading. **Rice v. Panchal**, 65 F.3d 637, 639 (7th Cir. 1995). The issues raised in the plaintiff's complaint, not those added in the defendant's response, control the litigation. **Jass v. Prudential Health Care Plan, Inc.**, 88 F.3d 1482, 1486 (7th Cir. 1996). For the most part

a “suit arises under the law that creates the cause of action.” ***Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 821 (1988).**

Here, Defendants have not sustained their burden of establishing federal question jurisdiction. **47 U.S.C. § 332(c)(3)(A)** provides in part:

Notwithstanding sections 152(b) and 221(b) of this title, no State or local government shall have any authority to regulate the entry of or the rates charged by any commercial mobile service or any private mobile service, except that this paragraph shall not prohibit a State from regulating the other terms and conditions of commercial mobile services.

The Court finds that the Early Cancellation Fee is not a part of Defendants’ rate-making structure or a part of market entry. The Court agrees with Chief Judge Murphy’s reasoning on this same issue in ***Kinkel v. Cingular Wireless, et al.*, 2002-0999-GPM**.² Chief Judge Murphy held:

“The only question is whether the LDP is really a rate adjustment. By its terms the LDP kicks in irrespective of how far into the term of the agreement the service is terminated. The customer who terminates on the 23rd month is treated the same as the one who walks away after a month of service. Moreover, there is no distinction made between agreements of different durations. The LDP provides for \$150 in liquidated damages regardless of the term of the agreement or whether the customer walks away from the service.

There is no question that a cellular provider could fashion an LDP that is undisputedly an integral part of its rate structure. But that is not the case here. All that can be said with certainty is that the LDP discourages the

² The allegations in ***Kinkel*** are exactly the same as the allegations in this case. The Defendants in ***Kinkel*** also removed the case arguing that the claims were preempted by **47 U.S.C. § 332(c)(3)(A)**.

customer from terminating service before the expiration of the agreement. This can serve legitimate and important business considerations, such as maintaining market share or holding down the market share of the competitors. These concepts, however, are different from rate structure. If the LDP was prorated or adjusted according to the terms of the agreement, this Court would look at things differently.

In short, the Court finds that the LDP is not part of Defendant's rate-making structure and, thus, it escapes federal preemption."

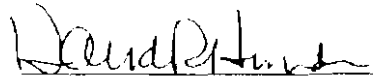
Kinkel, 2002-0999-GPM (Doc. 24, ps. 3-4). Thus, the Early Cancellation Fee in this matter is not part of the rate or market entry, but is one of Defendants' "other terms and conditions." Therefore, Zobrist's claims are not preempted by the FCA.

III. Conclusion

Because this Court lacks subject matter jurisdiction, the Court **GRANTS** Plaintiff's motion to remand (Doc. 20). The Court **REMANDS** this case to the Madison County, Illinois Circuit Court. Further, the Court **DENIES as moot** the remaining pending motions (Docs. 22, 24 & 27).

IT IS SO ORDERED.

Signed this 3rd day of December, 2002.


DAVID R. HERNDON
United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

FILED

NOV 03 2002

G. PATRICK MURPHY,
DISTRICT JUDGE
SOUTHERN DISTRICT OF ILLINOIS
EAST ST. LOUIS, ILLINOIS

DONNA M. KINKEL, Individually and On)
Behalf of Others Similarly Situated,)

Plaintiff,)

vs.)

CIVIL NO. 02-999-GPM

CINGULAR WIRELESS, SBC)
COMMUNICATIONS, INC., and)
BELLSOUTH CORPORATION,)

Defendants.)

MEMORANDUM AND ORDER

MURPHY, Chief District Judge:

Before the Court is Plaintiff's motion to remand (Doc. 12), which was argued November 4, 2002. The motion is granted.

This is a purported class action arising out of cellular phone service. Plaintiff, Donna Kinkel, claims that Defendants' "contract termination fee" is charged to penalize customers who cancel their cellular accounts, and, therefore, it is not a valid contract provision under state law. Her state court complaint consists of two counts: one for breach of contract and one for consumer fraud. According to Defendants, Plaintiff's claim is completely preempted by federal law, *see* 47 U.S.C. § 332(c)(3)(A), because it attacks the rates charged for cellular service. *See also Bastien v. AT&T Wireless Servs., Inc.*, 205 F.3d 983, 984 (7th Cir. 2000). Thus, Defendants argue that the case was

properly removed to this Court.¹

The question is whether the liquidated damages provision (LDP) in the “terms and conditions” section of the parties’ agreement is properly understood as part of the rate structure and, thus, preempted,² or whether it is simply a term or condition that escapes federal preemption.

The answer is not as clear to the Court as it is to the parties. Plaintiff’s position is that the LDP has nothing to do with rates at all. She paid the agreed monthly installments for a service and now no longer wants the service. The LDP is a penalty – that is the end of the matter. Stated differently, the parties agreed upon a rate for the service, and Plaintiff paid the agreed rate. What happened after the service was discontinued is beside the point. In Plaintiff’s view, the issue is outside of the preemption clause, falling instead within the “savings clause” to the Federal Communications Act. *See* 47 U.S.C. § 414 (“Nothing in this chapter contained shall in any way abridge or alter the remedies now existing at common law or by statute, but the provisions of this chapter are in addition to such remedies.”).

¹ The Court dismisses Plaintiff’s argument that Southwestern Bell Mobile Systems, LLC (d/b/a Cingular Wireless) [hereinafter “SBMS”], had no right to remove the action. SBMS has asserted that Cingular Wireless is a mere trade name under which it does business, and thus, SBMS the real party in interest. Plaintiff has failed to dispute this assertion.

² The Court does not reach the issue of complete preemption unless there is federal preemption in the first place. Ordinary federal preemption constitutes a federal defense to a state law cause of action; it does not support removal from state court. *See Bastien v. AT&T Wireless Servs., Inc.*, 205 F.3d 983, 986 (7th Cir. 2000). Complete preemption occurs “where there is a ‘congressional intent in the enactment of a federal statute not just to provide a federal defense to a state created cause of action but to grant a defendant the ability to remove the adjudication of the cause of action to a federal court by transforming the state cause of action into a federal cause of action.’” *Rogers v. Tyson Foods, Inc.*, No. 02-1040, 2002 WL 31367884 (7th Cir. Oct. 22, 2002) (quoting 14B Charles Alan Wright, Arthur R. Miller, & Edward H. Cooper, *FEDERAL PRACTICE AND PROCEDURE* § 3722.1 (3d ed. 1998 & Supp. 2002)). In the case of complete preemption, removal is proper in spite of the well-pleaded complaint rule. *See Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 63-64 (1987).

Defendants' position, in a nutshell, is that the \$150 specified as liquidated damages recoups the loss occasioned when a customer quits paying before the expiration of the agreed term for the service. The idea is that the actual cost of the service is spread over the entire agreed term so that the up-front costs are amortized according to the length of the term. This makes it possible for the service to be provided without a customer paying a hefty initial fee. Thus, the LDP falls squarely within its rate structure and is preempted.

Cingular could structure its rates so that a shorter term carried a higher initial fee. Similarly, rates could be structured so that the monthly fee is higher for a shorter term agreement. This being the case, it follows that Cingular could accomplish the same thing by adjusting the rate at the end when the customer does not continue with the service for the agreed term. In short, rate structure is no less rate structure because rates are computed at the end rather than the beginning of the service.

The only question is whether the LDP is really a retrospective rate adjustment. By its terms, the LDP kicks in irrespective of how far into the term of the agreement the service is terminated. The customer who terminates in the 23rd month is treated the same as one who walks away after one month of service. Moreover, there is no distinction made between agreements of different duration. The LDP provides for \$150 in liquidated damages regardless of the term of the agreement or when the customer walks away from the service.


There is no question that a cellular provider could fashion an LDP that is undisputedly an integral part of its rate structure. But that is not the case here. All that can be said with certainty is that the LDP discourages the customer from terminating service before the expiration of the agreement. This can serve legitimate and important business considerations, such as maintaining

market share or holding down the market share of competitors. These concepts, however, are different from rate structure. If the LDP was prorated or adjusted according to the term of the agreement, this Court would look at things differently.

In short, the Court finds that the LDP is not a part of Defendants' rate-making structure and, thus, it escapes federal preemption. Whether the LDP is enforceable under state law or whether it violates state law is for a state court to decide. The motion to remand (Doc. 12) is **GRANTED**, and this action is **REMANDED** to the Circuit Court for the Third Judicial Circuit, Madison County, Illinois, pursuant to 28 U.S.C. § 1447(c). The parties shall bear their own costs.

IT IS SO ORDERED.

DATED this 08th day of Nov., 2002.


G. PATRICK MURPHY
Chief United States District Judge

GAO

Report to the Ranking Minority Member,
Permanent Subcommittee on
Investigations, Committee on Homeland
Security and Governmental Affairs, U.S.
Senate

September 2006

CREDIT CARDS

Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers





Highlights of GAO-06-929, a report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

With credit card penalty rates and fees now common, the Federal Reserve has begun efforts to revise disclosures to better inform consumers of these costs. Questions have also been raised about the relationship among penalty charges, consumer bankruptcies, and issuer profits. GAO examined (1) how card fees and other practices have evolved and how cardholders have been affected, (2) how effectively these pricing practices are disclosed to cardholders, (3) the extent to which penalty charges contribute to cardholder bankruptcies, and (4) card issuers' revenues and profitability. Among other things, GAO analyzed disclosures from popular cards; obtained data on rates and fees paid on cardholder accounts from 6 large issuers; employed a usability consultant to analyze and test disclosures; interviewed a sample of consumers selected to represent a range of education and income levels; and analyzed academic and regulatory studies on bankruptcy and card issuer revenues.

What GAO Recommends

As part of revising card disclosures, the Federal Reserve should ensure that such disclosure materials more clearly emphasize those terms that can significantly affect cardholder costs, such as the actions that can cause default or other penalty pricing rates to be imposed. The Federal Reserve generally concurred with the report.

www.gao.gov/cgi-bin/getrpt?GAO-06-929.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-8678 or woodd@gao.gov

CREDIT CARDS

Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers

What GAO Found

Originally having fixed interest rates around 20 percent and few fees, popular credit cards now feature a variety of interest rates and other fees, including penalties for making late payments that have increased to as high as \$39 per occurrence and interest rates of over 30 percent for cardholders who pay late or exceed a credit limit. Issuers explained that these practices represent risk-based pricing that allows them to offer cards with lower costs to less risky cardholders while providing cards to riskier consumers who might otherwise be unable to obtain such credit. Although costs can vary significantly, many cardholders now appear to have cards with lower interest rates than those offered in the past; data from the top six issuers reported to GAO indicate that, in 2005, about 80 percent of their accounts were assessed interest rates of less than 20 percent, with over 40 percent having rates below 15 percent. The issuers also reported that 35 percent of their active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees in 2005.

Although issuers must disclose information intended to help consumers compare card costs, disclosures by the largest issuers have various weaknesses that reduced consumers' ability to use and understand them. According to a usability expert's review, disclosures from the largest credit card issuers were often written well above the eighth-grade level at which about half of U.S. adults read. Contrary to usability and readability best practices, the disclosures buried important information in text, failed to group and label related material, and used small typefaces. Perhaps as a result, cardholders that the expert tested often had difficulty using the disclosures to find and understand key rates or terms applicable to the cards. Similarly, GAO's interviews with 112 cardholders indicated that many failed to understand key aspects of their cards, including when they would be charged for late payments or what actions could cause issuers to raise rates. These weaknesses may arise from issuers drafting disclosures to avoid lawsuits, and from federal regulations that highlight less relevant information and are not well suited for presenting the complex rates or terms that cards currently feature. Although the Federal Reserve has started to obtain consumer input, its staff recognizes the challenge of designing disclosures that include all key information in a clear manner.

Although penalty charges reduce the funds available to repay cardholders' debts, their role in contributing to bankruptcies was not clear. The six largest issuers reported that unpaid interest and fees represented about 10 percent of the balances owed by bankrupt cardholders, but were unable to provide data on penalty charges these cardholders paid prior to filing for bankruptcy. Although revenues from penalty interest and fees have increased, profits of the largest issuers have been stable in recent years. GAO analysis indicates that while the majority of issuer revenues came from interest charges, the portion attributable to penalty rates has grown.

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Abbreviations

APR	Annual Percentage Rate
FDIC	Federal Deposit Insurance Corporation
OCC	Office of the Comptroller of the Currency
ROA	Return on assets
SEC	Securities and Exchange Commission
TILA	Truth in Lending Act

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United States Government Accountability Office
Washington, D.C. 20548

September 12, 2006

The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

Dear Senator Levin:

Over the past 25 years, the prevalence and use of credit cards in the United States has grown dramatically. Between 1980 and 2005, the amount that U.S. consumers charged to their cards grew from an estimated \$69 billion per year to more than \$1.8 trillion, according to one firm that analyzes the card industry.¹ This firm also reports that the number of U.S. credit cards issued to consumers now exceeds 691 million. The increased use of credit cards has contributed to an expansion in household debt, which grew from \$59 billion in 1980 to roughly \$830 billion by the end of 2005.² The Board of Governors of the Federal Reserve System (Federal Reserve) estimates that in 2004, the average American household owed about \$2,200 in credit card debt, up from about \$1,000 in 1992.³

Generally, a consumer's cost of using a credit card is determined by the terms and conditions applicable to the card—such as the interest rate(s), minimum payment amounts, and payment schedules, which are typically presented in a written cardmember agreement—and how a consumer uses

¹CardWeb.com, Inc., an online publisher of information about the payment card industry.

²Based on data from the Federal Reserve Board's monthly G.19 release on consumer credit. In addition to credit card debt, the Federal Reserve also categorizes overdraft lines of credit as revolving consumer debt (an overdraft line of credit is a loan a consumer obtains from a bank to cover the amount of potential overdrafts or withdrawals from a checking account in amounts greater than the balance available in the account). Mortgage debt is not captured in these data.

³B.K. Bucks, A.B. Kennickell, and K.B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, March 22, 2006. Also, A.B. Kennickell and M. Starr-McChuer, "Changes in Family Finances from 1989 to 1992: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, October 1994. Adjusted for inflation, credit card debt in 1992 was \$1,298 for the average American household.

a card.⁴ The Federal Reserve, under the Truth in Lending Act (TILA), is responsible for creating and enforcing requirements relating to the disclosure of terms and conditions of consumer credit, including those applicable to credit cards.⁵ The regulation that implements TILA's requirements is the Federal Reserve's Regulation Z.⁶ As credit card use and debt have grown, representatives of consumer groups and issuers have questioned the extent to which consumers understand their credit card terms and conditions, including issuers' practices that—even if permitted under applicable terms and conditions—could increase consumers' costs of using credit cards. These practices include the application of fees or relatively high penalty interest rates if cardholders pay late or exceed credit limits. Issuers also can allocate customers' payments among different components of their outstanding balances in ways that maximize total interest charges. Although card issuers have argued that these practices are appropriate because they compensate for the greater risks posed by cardholders who make late payments or exhibit other risky behaviors, consumer groups say that the fees and practices are harmful to the financial condition of many cardholders and that card issuers use them to generate profits.

You requested that we review a number of issues related to credit card fees and practices, specifically of the largest issuers of credit cards in the United States. This report discusses (1) how the interest, fees, and other practices that affect the pricing structure of cards from the largest U.S. issuers have evolved and cardholders' experiences under these pricing structures in recent years; (2) how effectively the issuers disclose the pricing structures of cards to their cardholders (3) whether credit card debt and penalty interest and fees contribute to cardholder bankruptcies; and (4) the extent to which penalty interest and fees contribute to the revenues and profitability of issuers' credit card operations.

To identify the pricing structures of cards—including their interest rates, fees, and other practices—we analyzed the cardmember agreements, as

⁴We recently reported on minimum payment disclosure requirements. See GAO, *Credit Cards: Customized Minimum Payment Disclosures Would Provide More Information to Consumers, but Impact Could Vary*, GAO-06-434 (Washington, D.C.: Apr. 21, 2006).

⁵Pub. L. No. 90-321, Title I, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1666).

⁶Regulation Z is codified at 12 C.F.R. Part 226.

well as materials used by the six largest issuers as of December 31, 2004, for 28 popular cards used to solicit new credit card customers from 2003 through 2005.⁷ To determine the extent to which these issuers' cardholders were assessed interest and fees, we obtained data from each of the six largest issuers about their cardholder accounts and their operations. To protect each issuer's proprietary information, a third-party organization, engaged by counsel to the issuers, aggregated these data and then provided the results to us. Although the six largest issuers whose accounts were included in this survey and whose cards we reviewed may include some subprime accounts, we did not include information in this report relating to cards offered by credit card issuers that engage primarily in subprime lending.⁸ To assess the effectiveness of the disclosures that issuers provide to cardholders in terms of their usability or readability, we contracted with a consulting firm that specializes in assessing the readability and usability of written and other materials to analyze a representative selection of the largest issuers' cardmember agreements and solicitation materials, including direct mail applications and letters, used for opening an account (in total, the solicitation materials for four cards and cardmember agreements for the same four cards).⁹ The consulting firm compared these materials to recognized industry guidelines for readability and presentation and conducted testing to assess how well cardholders could use the materials to identify and understand information about these credit cards. While the materials used for the readability and usability assessments appeared to be typical of the large issuers' disclosures, the results cannot be generalized to materials that were not reviewed. We also conducted structured interviews to learn about the card-using behavior and knowledge of various credit card terms and conditions of 112 consumers recruited by a market research organization to represent a range of adult income and education levels. However, our sample of cardholders was too

⁷These issuers' accounts constitute almost 80 percent of credit card lending in the United States. Participating issuers were Citibank (South Dakota), N.A.; Chase Bank USA, N.A.; Bank of America; MBNA America Bank, N.A.; Capital One Bank; and Discover Financial Services. In providing us with materials for the most popular credit cards, these issuers determined which of their cards qualified as popular among all cards in their portfolios.

⁸Subprime lending generally refers to extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Such issuers could have pricing structures and other terms significantly different from those of the popular cards offered by the top issuers.

⁹Regulation Z defines a "solicitation" as an offer (written or oral) by the card issuer to open a credit or charge card account that does not require the consumer to complete an application. 12 C.F.R. § 226.5a(a)(1).

small to be statistically representative of all cardholders, thus the results of our interviews cannot be generalized to the population of all U.S. cardholders. We also reviewed comment letters submitted to the Federal Reserve in response to its comprehensive review of Regulation Z's open-end credit rules, including rules pertaining to credit card disclosures.¹⁰ To determine the extent to which credit card debt and penalty interest and fees contributed to cardholder bankruptcies, we analyzed studies, reports, and bank regulatory data relating to credit card debt and consumer bankruptcies, as well as information reported to us as part of the data request to the six largest issuers. To determine the extent to which penalty interest and fees contributes to card issuers' revenues and profitability, we analyzed publicly available sources of revenue and profitability data for card issuers, including information included in reports filed with the Securities and Exchange Commission and bank regulatory reports, in addition to information reported to us as part of the data request to the six largest issuers.¹¹ In addition, we spoke with representatives of other U.S. banks that are large credit card issuers, as well as representatives of consumer groups, industry associations, academics, organizations that collect and analyze information on the credit card industry, and federal banking regulators. We also reviewed research reports and academic studies of the credit card industry.

We conducted our work from June 2005 to September 2006 in Boston; Chicago; Charlotte, North Carolina; New York City; San Francisco; Wilmington, Delaware; and Washington, D.C., in accordance with generally accepted government auditing standards. Appendix I describes the objectives, scope, and methodology of our review in more detail.

Results in Brief

Since about 1990, the pricing structures of credit cards have evolved to encompass a greater variety of interest rates and fees that can increase

¹⁰See Truth in Lending, 69 Fed. Reg. 70925 (advanced notice of proposed rulemaking, published Dec. 8, 2004). "Open-end credit" means consumer credit extended by a creditor under a plan in which: (i) the creditor reasonably contemplates repeated transactions, (ii) the creditor may impose a finance charge from time to time on an outstanding unpaid balance and (iii) the amount of credit that may be extended to the consumer is generally made available to the extent that any outstanding balance is repaid. 12 C.F.R. § 226.2(a)(20).

¹¹Although we had previously been provided comprehensive data from Visa International on credit industry revenues and profits for a past report on credit card issues, we were unable to obtain these data for this report.

cardholder's costs; however, cardholders generally are assessed lower interest rates than those that prevailed in the past, and most have not been assessed penalty fees. For many years after being introduced, credit cards generally charged fixed single rates of interest of around 20 percent, had few fees, and were offered only to consumers with high credit standing. After 1990, card issuers began to introduce cards with a greater variety of interest rates and fees, and the amounts that cardholders can be charged have been growing. For example, our analysis of 28 popular cards and other information indicates that cardholders could be charged

- up to three different interest rates for different transactions, such as one rate for purchases and another for cash advances, with rates for purchases that ranged from about 8 percent to about 19 percent;
- penalty fees for certain cardholder actions, such as making a late payment (an average of almost \$34 in 2005, up from an average of about \$13 in 1995) or exceeding a credit limit (an average of about \$31 in 2005, up from about \$13 in 1995); and
- a higher interest rate—some charging over 30 percent—as a penalty for exhibiting riskier behavior, such as paying late.

Although consumer groups and others have criticized these fees and other practices, issuers point out that the costs to use a card can now vary according to the risk posed by the cardholder, which allows issuers to offer credit with lower costs to less-risky cardholders and credit to consumers with lower credit standing, who likely would have not have received a credit card in the past. Although cardholder costs can vary significantly in this new environment, many cardholders now appear to have cards with interest rates less than the 20 percent rate that most cards charged prior to 1990. Data reported by the top six issuers indicate that, in 2005, about 80 percent of their active U.S. accounts were assessed interest rates of less than 20 percent—with more than 40 percent having rates of 15 percent or less.¹² Furthermore, almost half of the active accounts paid little or no interest because the cardholder generally paid the balance in full. The issuers also reported that, in 2005, 35 percent of their active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees.

¹²For purposes of this report, active accounts refer to accounts of the top six issuers that had had a debit or credit posted to them by December 31 in 2003, 2004, and 2005.

Although credit card issuers are required to provide cardholders with information aimed at facilitating informed use of credit and enhancing consumers' ability to compare the costs and terms of credit, we found that these disclosures have serious weaknesses that likely reduced consumers' ability to understand the costs of using credit cards. Because the pricing of credit cards, including interest rates and fees, is not generally subject to federal regulation, the disclosures required under TILA and Regulation Z are the primary means under federal law for protecting consumers against inaccurate and unfair credit card practices.¹³ However, the assessment by our usability consultant found that the disclosures in the customer solicitation materials and cardmember agreements provided by four of the largest credit card issuers were too complicated for many consumers to understand. For example, although about half of adults in the United States read at or below the eighth-grade level, most of the credit card materials were written at a tenth- to twelfth-grade level. In addition, the required disclosures often were poorly organized, burying important information in text or scattering information about a single topic in numerous places. The design of the disclosures often made them hard to read, with large amounts of text in small, condensed typefaces and poor, ineffective headings to distinguish important topics from the surrounding text. Perhaps as a result of these weaknesses, the cardholders tested by the consultant often had difficulty using these disclosures to locate and understand key rates or terms applicable to the cards. Similarly, our interviews with 112 cardholders indicated that many failed to understand key terms or conditions that could affect their costs, including when they would be charged for late payments or what actions could cause issuers to raise rates. The disclosure materials that consumers found so difficult to use resulted from issuers' attempts to reduce regulatory and liability exposure by adhering to the formats and language prescribed by federal law and regulations, which no longer suit the complex features and terms of many cards. For example, current disclosures require that less important terms, such as minimum finance charge or balance computation method, be prominently disclosed, whereas information that could more significantly affect consumers' costs, such as the actions that could raise their interest rate, are not as prominently disclosed. With the goal of improving credit card disclosures, the Federal Reserve has begun obtaining public and industry input as part of a comprehensive review of Regulation Z. Industry participants and others have provided various suggestions to improve

¹³TILA also contains procedural and substantive protections for consumers for credit card transactions

disclosures, such as placing all key terms in one brief document and other details in a much longer separate document, and both our work and that of others illustrated that involving consultants and consumers can help develop disclosure materials that are more likely to be effective. Federal Reserve staff told us that they have begun to involve consumers in the preparation of potentially new and revised disclosures. Nonetheless, Federal Reserve staff recognize the challenge of presenting the variety of information that consumers may need to understand the costs of their cards in a clear way, given the complexity of credit card products and the different ways in which consumers use credit cards.

Although paying penalty interest and fees can slow cardholders' attempts to reduce their debt, the extent to which credit card penalty fees and interest have contributed to consumer bankruptcies is unclear. The number of consumers filing for bankruptcy has risen more than sixfold over the past 25 years—a period when the nation's population grew by 29 percent—to more than 2 million filings in 2005, but debate continues over the reasons for this increase. Some researchers attribute the rise in bankruptcies to the significant increase in household debt levels that also occurred over this period, including the dramatic increase in outstanding credit card debt. However, others have found that relatively steady household debt burden ratios over the last 15 years indicate that the ability of households to make payments on this expanded indebtedness has kept pace with growth in their incomes. Similarly, the percentage of households that appear to be in financial distress—those with debt payments that exceed 40 percent of their income—did not change much during this period, nor did the proportion of lower-income households with credit card balances. Because debt levels alone did not appear to clearly explain the rise in bankruptcies, some researchers instead cited other explanations, such as a general decline in the stigma associated with bankruptcies or the increased costs of major life events—such as health problems or divorce—to households that increasingly rely on two incomes. Although critics of the credit card industry have cited the emergence of penalty interest rates and growth in fees as leading to increased financial distress, no comprehensive data exist to determine the extent to which these charges contributed to consumer bankruptcies. Any penalty charges that cardholders pay would consume funds that could have been used to repay principal, and we obtained anecdotal information on a few court cases involving consumers who incurred sizable penalty charges that contributed to their financial distress. However, credit card issuers said that they have little incentive to cause their customers to go bankrupt. The six largest issuers reported to us that of their active accounts in 2005 pertaining to cardholders who had filed for

bankruptcy before their account became 6 months delinquent, about 10 percent of the outstanding balances on those accounts represented unpaid interest and fees. However, issuers told us that their data system and recordkeeping limitations prevented them from providing us with data that would more completely illustrate a relationship between penalty charges and bankruptcies, such as the amount of penalty charges that bankrupt cardholders paid in the months prior to filing for bankruptcy or the amount of penalty charges owed by cardholders who went bankrupt after their accounts became more than 6 months delinquent.

Although penalty interest and fees have likely increased as a portion of issuer revenues, the largest issuers have not experienced greatly increased profitability over the last 20 years. Determining the extent to which penalty interest charges and fees contribute to issuers' revenues and profits was difficult because issuers' regulatory filings and other public sources do not include such detail. Using data from bank regulators, industry analysts, and information reported by the five largest issuers, we estimate that the majority—about 70 percent in recent years—of issuer revenues came from interest charges, and the portion attributable to penalty rates appears to have been growing. The remaining issuer revenues came from penalty fees—which had generally grown and were estimated to represent around 10 percent of total issuer revenues—as well as fees that issuers receive for processing merchants' card transactions and other sources. The profits of the largest credit-card-issuing banks, which are generally the most profitable group of lenders, have generally been stable over the last 7 years.

This report recommends that, as part of its effort to increase the effectiveness of disclosure materials, the Federal Reserve should ensure that such disclosures, including model forms and formatting requirements, more clearly emphasize those terms that can significantly affect cardholder costs, such as the actions that can cause default or other penalty pricing rates to be imposed. We provided a draft of this report to the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Trade Commission, the National Credit Union Administration, and the Office of Thrift Supervision for comment. In its written comments, the Federal Reserve agreed that current credit card pricing structures have added to the complexity of card disclosures and indicated that it is studying alternatives for improving both the content and format of disclosures, including involving consumer testing and design consultants.